

IT 99-16

Tax Type: Income Tax

Issue: Subpart F Income

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

**“ABC Corp., Inc”. and subsidiaries,
Taxpayer**

**No. 93-IT-0000
FEIN: 00-0000000
Tax yrs.: 1985 through 1989**

**Charles E. McClellan
Administrative Law Judge**

RECOMMENDATION FOR DECISION

Deborah H. Mayer for the Department of Revenue; Marilyn A. Wethekam of Horwood, Marcus & Berk for the taxpayer.

Synopsis:

This matter involves Notices of Deficiency ("NODs") issued by the Department to "ABC Corp., Inc". ("ABC") and affiliates (collectively referred to as "taxpayer") on April 16, 1993, and tentative denials of protective refund claims filed for the years at issue. The years involved are tax years 1985 through 1989. A pre-trial order was entered on June 18, 1998, setting forth the issues in the following terms:

1. Whether, for the tax years 1985, 1986 and 1987 ("Subpart F years), taxpayer is entitled to a subtraction modification under 35 ILCS 5/203(b)(2)(O) for income reported pursuant to Subpart F of the Internal Revenue Code. sections 951 *et. seq.*

2. Whether the income reported under Subpart F of the Internal Revenue Code sections 951 *et. seq.*,¹ is business income.
3. Whether the Internal Revenue Service's audit adjustment for tax year 1989 to increase the gain recognized by the taxpayer on the sale of certain foreign affiliates was properly characterized as business income by the Department.
4. Whether the Department has properly verified and calculated taxpayer's net operating losses incurred in tax year 1988 and properly carried forward net operating losses to tax year 1989.
5. Whether the Department's disallowance of a subtraction modification for income reported pursuant to Subpart F of the Internal Revenue Code sections 951 *et. seq.*, violates either the Due Process Clause and/or the Commerce Clause of the United States Constitution.
6. Whether taxpayer has demonstrated reasonable cause to warrant waiver of penalties imposed under 35 ILCS 5/1005.

At the evidentiary hearing held on March 24, 1999 the parties filed a stipulation of fact in lieu of presenting oral testimony. With regard to Issues 1 and 2, the parties stipulated that they would be bound by the decision of the court of highest jurisdiction in "ABC" Brands, Inc. and Subsidiaries v. Sam McGaw, Acting Director of the Department of Revenue of the State of Illinois, Dkt. No. 1-98-2901. The Appellate Court (1st Dist.) decided that case on June 30, 1999 holding that Subpart F income was not non-business income and that the taxpayer was not entitled to a subtraction modification for Subpart F income for 1983 and 1984. The court also held that the taxation of the taxpayer did not violate the Due Process Clause and/or the Commerce Clause of the United States Constitution thereby disposing of Issue 5 in this case. The Appellate Court's decision became final on July 30, 1999. Issues 3 and 4 in this case were resolved by the stipulation. (Stip. ¶¶ 108, 109) Thus, only Issue 6 remains for decision. That issue is whether taxpayer

¹ Subpart F refers to Sections 951-964 of the Internal Revenue Code of 1986. The Internal Revenue Code of 1954, as amended, was in effect for the first year involved in this case. Amendments to that Act which resulted in the Internal Revenue Code of 1986, do not affect the provisions involved in this case, so for convenience, all references to Internal Revenue Code sections ("IRC") refer to sections of the Internal Revenue Code of 1986.

has demonstrated reasonable cause to warrant waiver of penalties imposed under 35 ILCS 5/1005.

The taxpayer filed its post-hearing brief on April 30, 1999. The Department of Revenue filed its response on May 20, 1999 and the taxpayer filed a reply on June 4, 1999.

My recommendation is that the NODs and the tentative refund claim denials be adjusted in accordance with the stipulations of the parties (Stip. ¶¶ 108, 109), that the Subpart F income be classified as business income for which no subtraction modification is allowed and that penalties be abated. As so adjusted, the NODs should be made final.

Findings of Fact:

1. The Department has jurisdiction over the parties. Stip. ¶ 1.
2. “ABC” was incorporated under the laws of the State of “Bliss” on April 21, “1900” and during the years at issue, its principal offices were located at “711 Anywhere Drive, Someplace, USA”. Stip. ¶ 2.
3. During the years in issue, the “ABC” unitary business group was primarily engaged in the manufacture and wholesale sale of food products throughout the United States. Stip. ¶ 3.
4. “ABC” and the members of its unitary group which are required to file income tax returns in Illinois (“Illinois filers”) are as follows:

<u>Company Name</u>	<u>FEIN</u>
“ABC Corp, Inc.”	00-0000000
“Subsidiary #1”	00-0000000
“Subsidiary #2”	00-0000000
“Subsidiary #3”	00-0000000
“Subsidiary #4”	00-0000000
“Subsidiary #5”	00-0000000
“Subsidiary #6”	00-0000000
Stip. ¶ 4.	

5. “ABC”, as the common parent, timely filed a federal income tax return, for the tax years ended December 31, 1985 and December 31, 1986, on a consolidated basis including all domestic subsidiaries of which “ABC” owned 80% or more of the outstanding stock. Stip. ¶ 5.
6. “ABC -1, Inc.” (FEIN 00-0000000), as successor to “ABC”, filed a federal income tax return on a consolidated basis for the tax years ending December 31, 1987, December 31, 1988 and December 31, 1989. *Id.*
7. “ABC” unitary business group timely filed their Illinois income tax returns for the years in issue on a separate combined basis. Stip. ¶ 6.
8. The Illinois filers timely paid the tax shown due on the Illinois returns as filed for the years in issue. Stip. ¶ 7.
9. The Department audited the “ABC” unitary business group’s Illinois returns for the years in issue. Stip. ¶ 8.
10. On April 16, 1993, the Department timely issued Notices of Deficiency to the Illinois filers for the years in issue, proposing to assess additional tax. Stip. ¶ 9.
11. The amount of additional tax assessed is as follows:

<u>Company</u>	<u>Year Ended</u>	<u>Tax Deficiency</u>
“Subsidiary #2”	12/31/89	\$238,537
“Subsidiary #6”	12/31/89	161,557
“Subsidiary #1”	12/31/89	67,316
“Subsidiary #5”	08/31/85	251
“Subsidiary #4”	08/31/85	649
Total		\$468, 310
Stip. ¶ 10.		

12. In response to the Notices of Deficiency, the “ABC” unitary business group timely filed a Protest and Request for Hearing for the tax years in issue. Incorporated into that Protest were protective claims for refund filed on Forms IL 1120X for overassessments resulting from the Department’s audit adjustments for the following taxpayers:

<u>Company</u>	<u>Year Ended</u>	<u>Refund</u>
“Subsidiary #3”	12/31/89	\$717
“Subsidiary #4”	08/31/85	329
“Subsidiary #2”	12/31/85	4,865
“Subsidiary #2”	12/31/89	417,087
“Subsidiary #1”	12/31/89	106,889
Total		\$529,887

Stip. ¶ 11.

13. During the Subpart F years, “ABC” and members of its federal consolidated group owned directly or indirectly 80% or more of the outstanding stock of 28 "controlled foreign corporations" (“CFCs”), as defined in Section 957 of the IRC, which were incorporated in various countries in Central and South America, Europe, and the Far East. Stip. ¶¶ 13 through 97.
14. During the Subpart F years, the CFCs were not included in the “ABC” consolidated federal form 1120. Stip. ¶ 98.
15. As a result of “ABC’s” ownership of the CFCs, “ABC” reported Subpart F income on the consolidated federal returns pursuant to IRC Section 951(a). Stip. ¶ 99.
16. The amount of Subpart F income included in federal taxable income for the years at issue by the “ABC” unitary business group for the 1985 short period tax year is \$23,644,648; for the 1986 tax year, as corrected on audit by the Internal Revenue Service, is \$13,859,289 and for the 1987 tax year is \$74,880,195. Stip. ¶ 100.
17. In computing Illinois combined base income subject to apportionment for the tax years ended December 31, 1985, December 31, 1986 and December 31, 1987, the “ABC” unitary business group took subtraction modifications from Illinois base income for that portion of the income from the CFCs that was attributable to the Subpart F income. Stip. ¶ 103.
18. The amount of the subtraction modification for Subpart F income was \$23,644,648 for 1985, \$13,859,289 for 1986 and \$74,880,195 for 1987. Stip. ¶ 104.

19. For the tax year ended December 31, 1989, the “ABC” unitary business group properly characterized the gain recognized on the sale of foreign affiliates as non-business income as defined by 35 ILCS 5/1501(a)(13). Stip. ¶ 108.
20. The “ABC” unitary business group as a result of a federal audit filed an IL 1120X for the tax year ended December 31, 1989 and reported an additional gain in the amount of \$661,175 as a result of the sale of the foreign affiliates. The additional gain was properly reported on the amended 1989 “ABC” unitary business group IL 1120X as non-business income. Stip. ¶ 109.
21. The net operating losses incurred in the tax years ended December 31, 1986, December 31, 1987 and December 31, 1988 should be carried over to the tax year ended December 31, 1989 consistent with Act Section 207. Stip. ¶ 110.
22. “Subsidiary #6”, previously a division of “ABC”, was separately incorporated in October 1988 and included in the “ABC” unitary business for the tax years ended December 31, 1988 and December 31, 1989. Stip. ¶ 111.
23. On audit the Department concluded that “Subsidiary #6” should be included in the “ABC” Unitary Business Group. *Id.*
24. “Subsidiary #1” for the tax year ended December 31, 1989 timely made estimated income and replacement tax payments totaling \$300,000 against a corrected tax liability of \$119,380, leaving an overpayment of \$180,620. (Stip. ¶ 112, Ex. No. 36).
25. Taxpayer requested that the overpayment from “Subsidiary #1” be applied to its tax due, but the Department refunded \$23,533 to “Subsidiary #1” instead of applying the full amount to the tax due. (Stip. Ex. No. 6).

26. “Subsidiary #3” reported tax liability of \$23,517, reduced on audit to \$22,893, upon which the Department assessed Section 1005 penalties. *Id.*

C o n c l u s i o n s o f L a w :

S u b p a r t F I n c o m e a s B u s i n e s s o r N o n -
b u s i n e s s I n c o m e

The parties agreed to be bound by the Appellate Court’s decision in “Nabisco” Brands, Inc. and Subsidiaries v. Sam McGaw, Acting Director of the Department of Revenue of the State of Illinois, Dkt. No. 1-98-2901. The Appellate Court (1st Dist.) decided that case on June 30, 1999 holding that Subpart F income was not non-business income. Therefore, the taxpayer is not entitled to treat the Subpart F income as non-business income for the years involved in this case.

Subtraction Modification for Subpart F Income

The Appellate Court also decided that the taxpayer was not entitled to a subtraction modification for Subpart F income for 1983 and 1984. Therefore, the taxpayer is not entitled to a Subpart F income subtraction modification for 1985, 1986 or 1987.

Constitutional Issues

The constitutional issues raised by the taxpayer (violations of the Due Process Clause and the Commerce Clause of the United States Constitution) are the same as were addressed by the Appellate Court, i.e., whether denying the taxpayer a subtraction modification for the Subpart F income violates either of those clauses. The Appellate Court held that taxpayer’s rights under the Due Process Clause and the Commerce Clause were not violated by the denial. Therefore, the parties’ agreement to be bound by the Appellate Court’s decision dictates a conclusion that the taxpayer’s rights were not violated in this case.

Gain on Sale of Foreign Subsidiaries

The parties stipulated that for the tax year ended December 31, 1989, the gain recognized on the sale of foreign affiliates is non-business income. (See Stip. ¶¶ 108, 109, Stip. Exhibit 11). They also stipulated that the additional gain in the amount of \$661,175 recognized on the sale of the foreign affiliates as a result of a federal audit and which was reported on Form IL 1120X for the tax year ended December 31, 1989, should be taxed as non-business income. (See Stip. ¶ 109).

Net Operating Losses

The calculation and carry over of the net operating losses will be a mathematical determination based on the adjustments required as a result of the resolution of the issues in this case and in Nabisco Brands Inc., *supra*. (See Stip. ¶ 110)

Section 1005 Penalties

Before addressing the penalty assessment in its brief, the Department raised a procedural matter. It asserts that, “[T]axpayer in its brief on pages 27-28 introduces ‘new facts’ not contained anywhere in the record or the Stipulation of Facts, introduced for the first time in taxpayer’s brief after the ‘record’ had been closed (on March 24, 1999 with the exception of filing briefs).” The Department then states that, “any and all references to estimated tax payments, credits, or any other facts pertaining thereto must be stricken and disregarded” by me in determining whether reasonable cause exists. (Dept. Brief p. 44). The Department did not refer to any specific factual statements in the taxpayer’s brief that it believes are not supported by the record. However, after reviewing the record in light of taxpayer’s brief, I failed to find any particular factual references to factual matters in the brief that I consider to be relevant and material that were not supported by either the

stipulation or admitted exhibits attached thereto. Therefore, I decline to strike any part of taxpayers brief.

As to the penalties assessed, the Department imposed penalties under Section 1005 for the tax year 1989 against “Subsidiary #3, Subsidiary #1 and “Subsidiary #6”. The record shows that “Subsidiary #1” made estimated tax payments of \$300,000 against a corrected tax liability of \$119,380, leaving an overpayment of \$180,620. (Stip. ¶ 112, Stip. Ex. Nos. 6, 36). “Subsidiary #1” requested that the overpayment be applied to tax due, but the Department refunded \$23,533 to “Subsidiary #1” instead. (Stip. Ex. Nos. 6). “Subsidiary #3”, reported tax liability of \$23,517, made no estimated tax payments, and as a result of the audit, the liability was reduced by \$624 to \$22,893. *Id.* The Department assessed Section 1005 penalties against “Subsidiary #3”. *Id.* If the Department had applied the overpayment as requested by “Subsidiary #1”, there would have been no underpayment.

Section 1005(a), imposes a penalty for underpayment of tax as follows:

If any amount of tax required to be shown on the return prescribed by this Act is not paid on or before the date required for filing such return (determined without regard to any extension of time to file), a penalty shall be imposed in the manner and at the rate prescribed by the Uniform Penalty and Interest Act. (“UPIA”).

No penalty is assessed, however, if the taxpayer demonstrates that the underpayment was due to reasonable cause. (Section 1005(a), now Section 3-8 of the UPIA). The statute does not state what constitutes reasonable cause. The existence of reasonable cause must be determined on a case by case basis. Kroger Company v. Department of Revenue, 284 Ill.App.3d 473, 484 (1st Dist. 1996). Reasonable cause exists

if the taxpayer has exercised ordinary business care. *Id.*, 86 Admin. Code ch. I, § 700.400(c).

First, taxpayer argues that “Subsidiary #1” and “Subsidiary #3” each paid the amount of tax required to be shown on their tax returns prior to the due date for the year ended December 31, 1989. Second, it argues that taxpayer acted in good faith when it included “Subsidiary #6” in the “ABC-1” unitary group. The penalty with respect to “Subsidiary #6” results from the Department’s reclassification of “Subsidiary #6” to the “ABC” unitary group without giving “Subsidiary #6” credit for taxes paid by the “ABC-1” unitary group.

As to taxpayer’s first argument, that “Subsidiary #1 and “Subsidiary #3” each paid the amount of tax required to be shown on their tax returns prior to the due date, Stip. Ex. No. 36 indicates that for the year ended December 31, 1989, “Subsidiary #1” made estimated tax payments of \$300,000. It also shows that the corrected amount of tax for “Subsidiary #1” for that year was \$119,380. Thus, on the due date of the return there was an overpayment of the difference, \$180,620. Stip. Ex. No. 6 shows that “Subsidiary #3” made no estimated payments for 1989 and had a corrected tax liability of \$22,893. Taxpayer states in its brief (p. 27) that “Subsidiary #3” paid tax in the amount of \$23,533 for the tax year ended December 3, 1989. This amount exceeds the liability as determined by the Department by \$624.”

A footnote to the auditor’s penalty calculation schedule included in Stipulation Ex. No. 6 states that taxpayer requested that the overpayment of “Subsidiary #1” be applied to “Subsidiary #3” If the Department had honored that request, there would have been no deficiency upon which to assess the penalty. The record does not show that the

Department refused that request. The taxpayer had no reason to believe that the overpayment would not be applied as requested. The record shows that taxpayer exercised reasonable care. Therefore, the penalty assessed against “Subsidiary #3” should be abated.

The next aspect of the penalty assessment for consideration is the assessment that results from the reclassification of “Subsidiary #6” to the “ABC” unitary group from the “ABC-1” unitary group without giving “Subsidiary #6” credit for taxes paid by the “ABC-1” unitary group.

Although the record is somewhat unclear, it appears that “ABC”, including “Subsidiary #6” which was a division of “ABC” until October 1988, and its subsidiary corporations were combined in a corporate takeover in April 28, 1989. (Stip. Ex. No. 5.). The “ABC” unitary group and the “ABC-1” unitary group were then separate unitary groups under one corporate umbrella. *Id.* “Subsidiary #6” was included in the “ABC-1” unitary return for 1988 and 1989. *Id.* The Department reclassified “Subsidiary #6” into the “ABC” unitary group. *Id.* Taxpayer states that the income and the apportionment factors of “Subsidiary #6” were included in the income and apportionment factors of the “ABC-1” unitary group return for the tax years ended December 31, 1988 and December 31, 1989 and that estimated tax payments were calculated and paid on that basis. It argues that when the Department reclassified “Subsidiary #6” to the “ABC” group, it did not allow credit for the estimated tax paid by the group on behalf of “Subsidiary #6” and that gave rise to the underpayment on which the penalty assessment is based.

Section 1005 penalties are not imposed if the underpayment is due to reasonable cause. The Department’s regulation, 86 Admin. Code ch. I, § 700.400(c), provides that the most important factor in determining whether there is reasonable cause for penalty

abatement is the extent of the taxpayer's efforts in making a good faith attempt to comply with the law and if he exercises ordinary business care and prudence in the process.

Taxpayer states that there was an honest difference of opinion as to which unitary group "Subsidiary #6" belonged. That difference of opinion came about during the audit. What is important is the effort the taxpayer made at the time of filing its original return to make sure that it was complying with the law in classifying "Subsidiary #6" with the "ABC-1" unitary group. There is nothing in the record to indicate that taxpayer believed that it had classified "Subsidiary #6" with the wrong group when it filed its tax returns, so there is nothing to show that taxpayer failed to make a good faith effort to comply with the law at that time. In addition, when the auditor reclassified "Subsidiary #6", he failed to reclassify the estimated tax payments made on behalf of "Subsidiary #6" by the "ABC-1" unitary group and that failure is what gave rise to the underpayment. These factors indicate that taxpayer made a good faith effort to comply with the law at the time it filed the returns for 1988 and 1989. Therefore, there is reasonable cause to abate this portion of the penalty.

For the reasons stated above, I recommend that the NODs and the refund claims be adjusted as follows:

1. No subtraction modifications for Subpart F income in 1985, 1986 or 1987 should be allowed.
2. For the tax year ended December 31, 1989, the gain recognized on the sale of foreign affiliates is non-business income. (See Stip. ¶¶ 108, 109, Stip. Exhibit 11).

3. The additional gain in the amount of \$661,175 recognized on the sale of the foreign affiliates as a result of a federal audit and which was reported on Form IL 1120X for the tax year ended December 31, 1989, should be taxed as non-business income. (See Stip. ¶ 109).
4. The net operating losses incurred in the tax years ended December 31, 1986, December 31, 1987 and December 31, 1988 shall be carried over to the tax year ended December 31, 1989. (See Stip. ¶ 110 and Stip Exhibit 35).
5. The penalties assessed against “Subsidiary #3” and “Subsidiary #6” should be abated.

As so adjusted, the Notices of Deficiency and refund claims should be made final.

ENTER: November 29, 1999

Administrative Law Judge